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In the Supreme Court of the United States

OCTOBER TERM, 1948

No. —

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

H. R. SMITH

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit entered in this case.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 19-25) are reported at 10 T. C. 398. The opinion of the Court of Appeals (R. 61-62) is reported at 173 F. 2d 470.

JURISDICTION

The judgment of the Court of Appeals was entered on March 24, 1949. The jurisdiction of this

Court is invoked under 28 U. S. C., Section 1254 (1).

QUESTION PRESENTED

Under Sections 181-182 of the Internal Revenue Code, a member of a partnership is taxed upon his allocable share of the income earned by the partnership; that income is treated as ordinary income or capital gain depending upon the nature of the assets to which the income is attributable.

The question here presented is whether, as the court below held, the profit received by a taxpayer who retires as a member of a partnership, transferring his interest to others who continue the business, is to be taxed as capital gain rather than as ordinary income even though the partnership assets are non-capital assets (accounts receivable and ordinary assets), the income attributable to which would be taxed as ordinary income if the taxpayer had continued in the partnership.

STATUTE INVOLVED

The applicable provisions of the statute involved are set forth in the Appendix, *infra*, pp. 18-25.

STATEMENT

A portion of the facts in this case was stipulated (R. 26-31) and the remainder consisted of testimony and exhibits (R. 31-49). The following facts were found by the Tax Court:

The taxpayer is a resident of San Antonio, Texas, and filed his income tax return for 1942 with the

Collector of Internal Revenue for the First District of Texas (R. 19).

On or about June 11, 1941, the Hyman Supply Company, a partnership, was organized by Vance Hyman, Hugo Allen and the taxpayer, to engage in the business of selling oil field supplies in Alice, Texas. In this partnership, the taxpayer furnished all the capital, in the amount of $60,000. The other partners contributed their services. The taxpayer owned a 65 percent interest in the business, Hyman a 25 percent interest, and Allen a 10 percent interest. On December 31, 1942, the taxpayer sold his interest in the partnership to Vance Hyman, George T. Shumate and H. E. Harper (R. 20)—

Vance Hyman	25/65ths
George T. Shumate	30/65ths
H. E. Harper	10/65ths

At the time of the sale of the taxpayer's interest, the unpaid balance of the purchase price was secured to him by a mortgage on the partnership assets. The gain which he realized from the sale was $24,397.22. (R. 22.)

The partnership assets as of December 31, 1942, were as follows (R. 20-22):

Current Assets:			
Cash in Bank	$ 3,739.29		
Accounts Receivable—Trade	30,458.52		
Accounts Receivable—Other	1,239.21		
Notes Receivable	5,804.15		
Petty Cash	70.00		
Merchandise Inventory	46,296.57		$87,607.74
Fixed Assets:			
Automobiles and Trucks	$ 3,548.61		
Less reserve for depreciation	1,012.57	$ 2,536.04	
Buildings	3,520.16		
Less reserve for depreciation	545.31	2,974.85	
Furniture and Fixtures	702.00		
Less reserve for depreciation	88.83	613.17	
Machinery and Equipment	540.35		
Less reserve for depreciation	108.07	432.28	
Land		1,301.25	
			$ 7,857.59
Deferred Charges:			
Cash Deposits		$ 135.00	
Miscellaneous Inventories		1,200.00	
Prepaid Insurance		201.68	$ 1,536.68
			$97,002.01

Liabilities and Net Worth

Current Liabilities:			
Accounts Payable		$23,593.50	
Accrued Taxes Payable		18.76	
Reserve for Federal Taxes Withheld		12.46	$23,624.72
Other Liabilities:			
Accrued Interest Payable			$ 4,980.13
Net Worth:			
H. R. Smith		$62,078.24	
Vance Hyman		4,460.72	
Hugo Allen		1,858.20	$68,397.16
			$97,002.01

The date of the acquisition of the fixed assets set out above and their cost is as follows (R. 22):

Schedule of Fixed Assets

December 31, 1942

	Date Acquired	Cost
Autos and Trucks:		
1—1940 Chevrolet Truck	7-26-41	$1,155.31
1—1941 Chevrolet Truck	12- 1-41	1,150.00
1—1942 Chevrolet Sedan	11-12-42	1,243.30
		$3,548.61
Buildings:		
Store Building	5-22-42	$2,500.00
Loading Platforms and Racks	Various 1941	788.67
Loading Platforms and Racks	1-30-42	39.50
Loading Platforms and Racks	12-31-42	191.99
		$3,520.16

The Commissioner determined a deficiency in income tax which resulted, in part, from his conclusion that the gain on the sale was ordinary income and should not have been reported as capital gain (R. 8-16). The Tax Court held that the gain was taxable as capital gain and refused to sustain the deficiency determination (R. 23-25). The

Court of Appeals affirmed, holding that the taxpayer had an interest in the partnership which was an intangible asset under Texas law and that it was a capital asset (R. 61-62).

It will be noted that while the taxable transaction took place in 1942, the taxable year involved is 1943. This is due to the forgiveness features of Section 6 of the Current Tax Payment Act of 1943, c. 120, 57 Stat. 126.

REASONS FOR GRANTING THE WRIT

1. The issue decided by the court below is one of considerable importance in the administration of the income tax laws and one which ought to be determined by this Court. The holding here is that a partner, who sells his rights in a going partnership business at a profit, has sold a capital asset and is in receipt of capital gain, rather than ordinary income, despite the fact that some of the business assets transferred to the incoming or continuing partners are non-capital assets. This precise tax problem, it is evident, will arise practically every time the composition of a partnership is altered by the withdrawal of a partner, the remaining partners continuing the business, or by the addition of a new member to the firm upon the withdrawal of a retiring partner, or upon the expansion of the partnership by the admission of a new member. The constant recurrence of these transactions in the business world manifests the need for an authorita-

tive decision by this Court on how the attendant gain or loss should be taxed.

The importance to the revenue of a correct solution to this problem becomes evident from the manner in which the decision below permits a taxpayer to have the special benefits of the lower rate of tax on capital gains even though, had he remained a partner, the same essential gains would have been taxable to him as ordinary income when they were collected by the firm. In the present case, a large portion of the partnership assets consisted of accounts receivable, the income from which, as collected, would have been taxable as ordinary income to the taxpayer and to his partners. Yet the decision below permits the taxpayer, who transferred his interest in these receivables to the members of the new firm, to treat the gain attributable to these receivables as though it were capital gain. The same observations are also pertinent with respect to the remaining partnership property, all of which constituted ordinary assets, such as inventory used in the business, and depreciable property. If the conversion of ordinary income into capital gain can be accomplished with such facility under the present statute, to the obvious detriment of the revenue, such a conclusion ought to be announced by this Court and should not rest on the decisions of the lower courts.

The present decisions of the lower courts, moreover, are in a most unsatisfactory state and, so long

as they remain that way, it is not possible for the Commissioner to determine what position should be taken in the administration of the statute. The Court of Appeals for the Ninth Circuit, for example, in *Stilgenbaur* v. *United States,* 115 F. 2d 283, ruled that a partner could sell either his so-called interest in the partnership, or his interest in the specific partnership assets, and that when the latter was the form of the sale the nature of the gain was to be determined from the nature of the specific partnership assets.[1] Yet, in its recent decision in *Commissioner* v. *Estate of Gartling,* 170 F. 2d 73, where the transfer did take the form of a sale of the partner's interest in the specific partnership assets, that court, in a *per curiam* affirmance, sustained the Tax Court's decision to the effect that the gain was capital gain, regardless of the fact that the partnership assets were ordinary assets. The enigmatic state of the rule to be applied in that circuit is made even more puzzling by the fact that the *per curiam* decision in the *Gartling* case rested on the authority of the *Stilgenbaur* case. Similarly, in *Commissioner* v. *Shapiro,* 125 F. 2d 532, the Court of Appeals for the Sixth Circuit has held that gain realized by a partner on retirement from the firm is to be taxed as capital gain. The rationale of the

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[1] The Commissioner does not agree that such a differentiation is valid and that a partner is any the less selling his interest in specific partnership property when the sale is in the form of a transfer of a partnership interest than when it is stated to be a transfer of specific assets.

opinion is far from clear and, though many of the partnership assets there may have been capital assets and the gain, in whole or part, may have been attributable to those assets, it is not possible to determine from the *Shapiro* decision what is the position of that circuit.

In *Doyle* v. *Commissioner,* 102 F. 2d 86 (C. A. 4th), where the withdrawing member received a lump sum payment from his partner on account of his interest in an uncollected, disputed legal fee, the court held that the gain was ordinary income, emphasizing that it would have been taxed in this manner if the fee had been collected by the partnership and divided among the respective partners. Had the principle of the case been applied by the court below, the result should have been different, at least so far as the taxpayer's interest in the accounts receivable is concerned. Similarly, in *Helvering* v. *Smith,* 90 F. 2d 590, the Court of Appeals for the Second Circuit held that the amount received by a retiring partner of a law firm was taxable as ordinary income where the payment was received in satisfaction of his share of the earnings collected after dissolution of the firm.[2] In *McClellan* v.

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[2] In *McAfee* v. *Commissioner,* 9 T.C. 720, the taxpayer withdrew from a law partnership, receiving a lump sum payment from the partners who continued the firm, the payment being subject to adjustment, depending on the fees collected thereafter for legal services performed prior to the taxpayer's withdrawal. The Tax Court held (pp. 726-727) that the taxpayer "did not sell an interest in the partnership firm or in the assets of the firm" (which were of negligible value) but that this was a "partnership dissolution by which the partners settled their

Commissioner, 117 F. 2d 988, and *Munson* v. *Commissioner,* 100 F. 2d 363, that court held that the retiring partner had a capital transaction where the principal partnership asset was a seat on the stock exchange. These decisions seem correct in that the assets were capital assets and, as the *Munson* case recognized (p. 366), the retiring partner was selling his interest in that asset to his former partner. However, in *Commissioner* v. *Lehman,* 165 F. 2d 383, certiorari denied, 334 U. S. 819, where the issue related to the determination of the proper holding period for calculating capital gain (rather than to the nature of the gain) the court announced the view that the partner possessed an interest in the firm, separate from the partnership assets, which could be viewed as a capital asset and that, upon the transfer of this interest, the time that it was held depended upon the length of time that he had been a partner. The *Lehman* case, which followed similar decisions of the Third Circuit in *Thornley* v. *Commissioner,* 147 F. 2d 416, and *Kessler* v. *United States,* 124 F. 2d 152, is squarely in conflict with the decision of the Court of Claims in *City Bank Farmers Trust Co.* v. *United States,* 47 F. Supp. 98.

We believe that an authoritative decision which can clarify this murky state of the precedents can be announced only by this Court.

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respective rights in the subsequent earnings of the partnership." We submit that the present case, in so far as the taxpayer's interest in the accounts receivable is concerned, is indistinguishable from the *McAfee* case.

On this state of the law, some lower courts, rejecting the view taken by the Court of Claims, have been persuaded that a sale of a partner's so-called interest in the firm is clearly the sale of a capital asset and that it is always taxable as such. This was true of the decision below. It was also true in *Shapiro* v. *United States,* 83 F. Supp. 375 (D. Minn.), pending on the Government's appeal in the Court of Appeals for the Eighth Circuit. It is also true of the decision of the Tax Court in this and other recent cases. It is important, accordingly, that the guidance of this Court be furnished in order that the lower courts may not continue to decide these matters on the basis of precedents which, at best, do not contain a clear and consistent treatment of this tax problem.

Finally, the importance of the question must also be manifest from the fact that the interested partner may suffer a loss as well as a gain when the shift in the composition of the partnership takes place; the decision below, while favorable to the taxpayer here, would be detrimental to those who suffer losses attributable to ordinary assets used in the partnership business. But so long as the Court of Claims adheres to the position announced in *City Bank Farmers Trust Co.* v. *United States,* 47 F. Supp. 98, such taxpayers would be able to obtain favorable decisions for refunds in that court even if the Commissioner were to feel justified, despite the state of the authorities, in changing his administrative position in reliance on the decision

below. Where the conflict in decisions, as here, creates a situation in which taxpayers can, by choosing their forum, successfully resist the application of any consistent principle, the necessity that the problem be settled decisively by this Court seems abundantly clear. A mere change in the Commissioner's administrative construction of the statute cannot possibly protect the revenue while such a conflict persists.

2. The decision is wrong. The court below taxes a partner who disposes of his interest in the partnership business exactly as it would a stockholder who sells his stock in a corporation. Actually, since Congress has seen fit to distinguish sharply between the method of taxing stockholders and partners, the contrary conclusion is required. A partnership is not a taxable entity; instead, treating the partners as the common owners of the business assets, the earnings of the business are taxed only to the partners and without regard to whether the profits are distributed to them. Sections 181-182, Internal Revenue Code (Appendix, *infra,* pp. 20-21). Significantly, too, the character of the partnership income, i.e., whether capital gain or ordinary income, retains its identity and is taxable to the partners as though they had directly sold assets in which they shared a common ownership. Sections 182-183, Internal Revenue Code (Appendix, *infra,* pp. 20-22). Charitable contributions made by the firm are also considered as having been made by the

individual partners proportionately (Section 183 (c), Internal Revenue Code), and the benefit of a carry-back or carry-over of net operating losses is allowed only to the individual partners (Section 189, Internal Revenue Code (Appendix, *infra,* p. 24)). Further, the statutory definition of a partnership is not limited to organizations which qualify as such under local law, but includes other business groups in which the members are the common owners of the assets used in the business. Section 3797 (a)(2), Internal Revenue Code (Appendix, *infra,* p. 25). It seems plain, accordingly, that Congress never envisaged that when a partner severs his relationship with the firm, and transfers his interest in the partnership assets to others, the nature of those assets should be competely disregarded in the attribution of gain or loss, as did the court below. Nor did Congress intend that a partner who, while he remains a partner, possesses, for tax purposes, no distinct interest in the business which can be disassociated from his interest in the specific partnership assets, should be regarded as having an interest in the business which can be disposed of when he leaves the firm and which can be classified, *per se,* as a capital asset. Congress certainly did not intend, as is true of the accounts receivable here, that a partner's interest in income which only remains to be collected by the firm should be able to be anticipated in the form of a lump sum payment taxable as capital gain.

A corporation, on the contrary, is a taxable entity. The corporate profits are taxable to the corporation, not the stockholder, since he is not considered as possessing a direct interest in the corporate property or its earnings. *United States* v. *Joliet & Chicago R. Co.*, 315 U. S. 44; *National Carbide Corp.* v. *Commissioner*, 336 U. S. 422. The stockholder is taxed only on the distributions made to him, and the nature of the dividend income depends, not on the nature of the corporate gains, but only on whether the distribution is out of the corporation's earnings and profits. Section 115, Internal Revenue Code. The stockholder's stock interest in the corporation, being distinct from the corporation's interest in its property and profits, is itself "property" which can be sold and which, being property held by a taxpayer, can qualify as a capital asset under Section 117 (a)(1) of the Internal Revenue Code (Appendix, *infra*, pp. 18-19). Quite clearly, the same cannot be true under the taxing statute of a partner's interest in the firm. The court below erred in holding to the contrary.

A further vice of the decision below is that it rests on the nature of a partner's interest in the partnership under Texas law. This is the holding, despite the fact that Congress has employed its own definition in Section 3797 (a)(2), Internal Revenue Code, which is designed to insure a uniform, nationwide taxing scheme—a definition which, as has been shown, is not limited to organizations that

qualify as partnerships under local law. Cf. *Burk-Waggoner Assn.* v. *Hopkins,* 269 U. S. 110. By departing from this definition, the court below makes varying rules of local law the pattern where Congress supplied a single, uniform standard, and imparts differences between business organizations where none was intended by the taxing statute. The fallacy of using local law is apparent since the court held that the taxpayer sold an intangible, i.e., his interest in the firm's (R. 62) "surplus." Such a concept is meaningless under the taxing statute, for prior profits will have been already taxed to the partner even though reinvested in new firm assets, and his interest in future profits not yet collected, such as accounts receivable, or assets which have appreciated in value, does not represent an intangible, capital asset that can be disassociated from existing firm assets. The present case does not show a going concern value, but in a proper situation this would also be an asset in which the partners have an interest.

3. There is a conflict in decision which should be resolved by this Court. As the court below recognized (R. 62), its decision conflicts in principle with that of the Court of Claims in *City Bank Farmers Trust Co.* v. *United States,* 47 F. Supp. 98. There the court, ruling that the provisions of the taxing statute and not local law governed, held that, for tax purposes, the partners possess an interest in the specific partnership assets, that the

partners do not possess a separate interest in the firm which can be the subject matter of sale, that when an interest in the partnership is transferred, all that is sold is an interest in the partnership assets, and that, when those assets are capital assets, the holding period for ascertaining the percentage limitations on taxing capital gain is determined by the lengths of time that the assets have been held by the firm. It refused to hold that there was a partnership interest which was sold and which, itself, was a capital asset held for the length of time that the partnership interest was held. It is apparent that if the court below had followed, instead of rejecting the principle of the *City Bank Farmers Trust Co.* case, it would have reached the opposite result here.

The decision below also conflicts in principle with the decisions in *Doyle* v. *Commissioner,* 102 F. 2d 86 (C. A. 4th), and in *Helvering* v. *Smith,* 90 F. 2d 590 (C. A. 2d). In each instance, the receipt of a lump sum payment, in lieu of an interest in partnership earnings not yet collected, was held to be taxable as ordinary income. Those cases should have led the court here to hold that the taxpayer received ordinary income, at least to the extent that the price received constituted payment for his interest in the partnership earnings represented by the accounts receivable. See also *Bull* v. *United States,* 295 U. S. 247.

4. In *Commissioner* v. *Lehman,* 165 F. 2d 383 (C. A. 2d), certiorari denied, 334 U. S. 819, where the issue related to the proper holding period for determining capital gain, the petition for a writ of certiorari asserted that the decision might be sufficiently broad to compel the conclusion (p. 15) "that a sale of a partnership interest would be a sale of a capital asset even though the assets used in the business are non-capital in nature." The present case is an instance in which the *Lehman* decision was so regarded, as is *Shapiro* v. *United States,* 83 F. Supp. 375 (D. Minn.), pending on the Government's appeal in the Court of Appeals for the Eighth Circuit. Accordingly, notwithstanding the denial of certiorari in *Lehman,* we are constrained, in the interest of an orderly administration of the revenue laws, to request that certiorari issue here to review the rejection, by the court below, of the Commissioner's interpretation of the applicable statutory provisions. The weighty and cogent reasons already set forth seem to us to demand such reconsideration of the problem heretofore presented in the *Lehman* case as may be necessary to dispose of the issue here involved.

CONCLUSION

This petition for a writ of certiorari should be granted.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.

JUNE, 1949.

APPENDIX

Internal Revenue Code:

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(13) *Partnerships.*—If the property was acquired, after February 28, 1913, by a partnership and the basis is not otherwise determined under any other paragraph of this subsection, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. If the property was distributed in kind by a partnership to any partner, the basis of such property in the hands of the partner shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property.

* * * * *

(26 U.S.C. 1946 ed., Sec. 113.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) [As amended by Section 115(b), Revenue Act of 1941, c. 412, 55 Stat. 687, and Section 151(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Capital Assets.*—The term "capital

assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), or an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, or real property used in the trade or business of the taxpayer.

* * * * *

(4) [As amended by Section 150(a), Revenue Act of 1942, *supra*] *Long-Term Capital Gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

* * * * *

(b) [As amended by Section 150 (c), Revenue Act of 1942, *supra*] *Percentage Taken Into Account.*—In the case of a taxpayer other than a corporation, only the following percentages of the gain or loss recognized upon the sale or ex-

change of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than 6 months.

* * * * *

(26 U.S.C. 1946 ed., Sec. 117.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

(26 U.S.C. 1946 ed., Sec. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

(a) [As amended by Section 150 (g), Revenue Act of 1942, *supra*] As part of his gains and losses from sales or exchanges of capital assets held for not more than 6 months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for not more than 6 months.

(b) [As amended by Section 150 (g), Revenue Act of 1942, *supra*] As part of his gains and losses from sales or exchanges of capital assets held for more than 6 months, his distributive share of the gains and losses of the partner-

ship from sales or exchanges of capital assets held for more than 6 months.

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b).

(26 U.S.C. 1946 ed., Sec. 182.)

SEC. 183. COMPUTATION OF PARTNERSHIP INCOME.

(a) *General Rule.*—The net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual, except as provided in subsections (b) and (c).

(b) [As amended by Section 150 (g), Revenue Act of 1942, *supra*] *Segregations of Items.*—

(1) *Capital Gains and Losses.*—There shall be segregated the gains and losses from sales or exchanges of capital assets.

(2) *Ordinary Net Income or Loss.*—After excluding all items of gain and loss from sales or exchanges of capital assets, there shall be computed—

(A) An ordinary net income which shall consist of the excess of the gross income over the deductions; or

(B) An ordinary net loss which shall consist of the excess of the deductions over the gross income.

(c) *Charitable Contributions.*—In computing the net income of the partnership the so-called "charitable contribution" deduction allowed by section 23 (o) shall not be allowed; but each partner shall be considered as having made

payment, within his taxable year, of his distributive portion of any contribution or gift, payment of which was made by the partnership within its taxable year, of the character which would be allowed to the partnership as a deduction under such section if this subsection had not been enacted.

(26 U.S.C. 1946 ed., Sec. 183.)

SEC. 184 [As amended by Section 126 (f), Revenue Act of 1942, *supra*]. CREDITS AGAINST NET INCOME.

The partner shall, for the purpose of the normal tax, be allowed as a credit against his net income, in addition to the credits allowed to him under section 25, his proportionate share of such amounts (not in excess of the net income of the partnership) of interest specified in section 25 (a) as are received by the partnership. If the partnership elects under section 125 to treat the premium on bonds, the interest on which is allowable as a credit under section 25 (a) (1) or (2), as amortizable, for the purposes of the preceding sentence the partner's proportionate share of the interest received by the partnership shall be his proportionate share of such interest (determined without regard to this sentence) reduced by so much of the deduction under section 23 (v) as is attributable to such share.

(26 U.S.C. 1946 ed., Sec. 184.)

SEC. 185. EARNED INCOME.

In the case of the members of a partnership the proper part of each share of the net income which

consists of earned income shall be determined under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary and shall be separately shown in the return of the partnership.

(26 U.S.C. 1946 ed., Sec. 185.)

SEC. 186. TAXES OF FOREIGN COUNTRIES AND POSSESSIONS OF UNITED STATES.

The amount of income, war-profits, and excess-profits taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the tax of the member of a partnership to the extent provided in section 131.

(26 U.S.C. 1946 ed., Sec. 186.)

SEC. 187. PARTNERSHIP RETURNS.

Every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this chapter and such other information for the purpose of carrying out the provisions of this chapter as the Commissioner with the approval of the Secretary may by regulations prescribe, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners.

(26 U.S.C. 1946 ed., Sec. 187.)

SEC. 188. DIFFERENT TAXABLE YEARS OF PARTNER AND PARTNERSHIP.

If the taxable year of a partner is different from that of the partnership, the inclusions with respect to the net income of the partnership, in computing the net income of the partner for his taxable year, shall be based upon the net income of the partnership for any taxable year of the partnership (whether beginning on, before, or after January 1, 1939) ending within or with the taxable year of the partner.

(26 U.S.C. 1946 ed., Sec. 188.)

SEC. 189 [As added by Section 211 (d), Revenue Act of 1939, c. 247, 53 Stat. 862]. NET OPERATING LOSSES.

The benefit of the deduction for net operating losses allowed by section 23 (s) shall not be allowed to a partnership but shall be allowed to the members of the partnership under regulations prescribed by the Commissioner with the approval of the Secretary.

(26 U.S.C. 1946 ed., Sec. 189.)

SEC. 190 [As added by Section 155 (h), Revenue Act of 1942, *supra*]. ALLOWANCE OF AMORTIZATION DEDUCTION.

In the case of emergency facilities of a partnership, the benefit of the deduction for amortization allowed by section 23 (t) shall not be allowed to the members of a partnership but shall be allowed to the partnership in the same manner

and to the same extent as in the case of an individual.

(26 U.S.C. 1946 ed., Sec. 190.)

SEC. 3797. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * * * *

(2) *Partnership and Partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

* * * * *

(26 U.S.C. 1946 ed., Sec. 3797.)

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1949.

No. 120.

COMMISSIONER OF INTERNAL REVENUE, *Petitioner,*

v.

H. R. SMITH, *Respondent.*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit.

BRIEF OF THE RESPONDENT IN OPPOSITION.

Opinions Below.

The findings of fact and opinion of The Tax Court of the United States (R. 19-25) are reported at 10 T. C. 398. The opinion of the Court of Appeals (R. 61-62) is reported at 173 F. (2d) 470.

Jurisdiction.

The judgment of the Court of Appeals was entered March 24, 1949. Petition for a writ of certiorari was filed June 14, 1949. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254(1).

Question Presented.

On July 11, 1941, the taxpayer and two other persons organized a partnership known as "Hyman Supply Company." The Hyman Supply Company operated as a retailer of oil field supplies in Alice, Texas. The taxpayer furnished the necessary capital to the partnership and the other partners contributed their services. The taxpayer owned a sixty-five per cent interest in the partnership. On December 31, 1942, the taxpayer sold his undivided interest in the partnership to one of the remaining partners and two other persons.

The question for decision is: Was the sale by the taxpayer of his undivided partnership interest the sale of a capital asset? The Tax Court and the Court of Appeals held that the sale was the sale of a capital asset.

Petitioner's statement of the question is misleading and contrary to fact in a very important aspect. The petition states (p. 2) that the income attributable to accounts receivable would be taxed as ordinary income if the taxpayer had continued in the partnership. There is no justification in the record for such a statement.

The fact is that the partnership books were kept on the accrual basis. Consequently, the accounts receivable shown as assets of the partnership had been taken into partnership income prior to the sale. Taxpayer's distributable portion of such accounts receivable were income to him prior to the sale. By paying the capital gain tax, the taxpayer in reality has paid tax twice on these accounts receivable.

Statement of Facts.

The facts as set forth at pages 2-6 of the petition are correct. The taxpayer sees no need for making a counterstatement.

Argument.

The law is judicially and legislatively settled as decided below.

Beginning in 1935, The Tax Court and various Circuit Courts of Appeal have consistently held that the sale of an interest in a partnership is taxable as the sale of a capital asset. The first case is *Dudley T. Humphrey,* 32 B. T. A. 280. In that case, a retiring partner sold his partnership interest to the remaining partners. The Board there held that the sale of the undivided partnership interest constituted the sale of a capital asset and at pages 283-284 said:

> "Now, applying the above holdings to the present case, it would appear that what petitioner sold to his partners was an intangible consisting of his right to a share in the net value of the partnership after settlement of its affairs. He had no interest in the assets of the partnership as such; consequently, what he sold was not a portion of or an interest in the partnership securities. His interest in the partnership was separate and distinct from his coownership of the partnership assets and the length of time of his ownership of the partnership interest is not measurable by the period of time that the partnership had owned the securities on hand at the time he sold his interest. He had owned his interest more than two years and in our opinion it constituted a capital asset in his hands."

The Tax Court has repeatedly held that the sale of a partnership interest constitutes the sale of a capital asset and the gain or loss which results is taxable under the provisions of Section 117 of the Internal Revenue Code. See *Estate of Daniel Gartling,* P-H T. C. Memo. Decs. ¶ 47,213, affirmed (CCA-9, Oct. 21, 1948), (170 F. (2d) 73); *L. F. Long,* T. C. Memo. (3/29/47), P-H T. C. Memo. Decs. ¶ 47,155, affirmed (CCA-5) 173 F. (2d) 471, pending before this Court on petition for a writ of certiorari, No. 121; cf. *John Whitney,* T. C. Memo. (9/12/45) P-H T. C. Memo.

Decs. ¶ 45,285; *Estate of W. T. Jones*, T. C. Memo. (2/5/44) P-H T. C. Memo. Decs. ¶ 44,028; *Frank B. Killian*, T. C. Memo. (4/27/44) P-H T. C. Memo. Decs. ¶ 44,244 (In this case the Commissioner conceded that a partnership interest was a capital asset.); *Ad. Auriema, Inc.*, T. C. Memo. (9/17/43) P-H T. C. Memo. Decs. ¶ 43,422; *H. V. B. Smith*, 5 T. C. 323; *John G. Ogden*, (6/30/49) 12 T. C. No. 158.

The various United States Circuit Courts of Appeal have likewise held that the sale of an undivided partnership interest constitutes the sale of a capital asset. This was the holding in the case of *Morris Shapiro*, B. T. A. Memorandum Opinion 1/20/40, affirmed (CCA-6) 125 F. (2d) 532, 28 A. F. T. R. 1079 (1942). In that case the Sixth Circuit, in affirming the decision of the Board said (page 1082):

> "It is fundamental in applying tax statutes that matters of substance are of first importance. The price paid for the property in question may have been based partly on assets excluded under the act from the phrase 'capital assets' such as inventories or property held by the partnership primarily for sale to customers in the ordinary course of its trade or business, but the sale made by respondent was not a sale of those assets. It is a well settled rule of law that the joint effects of a partnership belong to the firm and not the partners and that a partner has no individual property in any specific assets of the firm, instead the interest of each partner in the partnership property is his share in the surplus, after the partnership debts are paid and after the partnership accounts are settled. *Blodgett* v. *Silberman*, 277 U. S. 1, 10, 48 S. Ct. 410, 72 L. Ed. 749. Respondent sold all of his interest in the partnership, tangible and intangible, as a going concern, which in all essentials is different from the ordinary assets of the partnership used in the usual course of its business. * * *"

See, also, *Munson* v. *Commissioner* (CCA-2), 100 F. (2d) 363, 22 A. F. T. R. 97; *Hill* v. *Commissioner* (CCA-1), 38 F. (2d) 165, 8 A. F. T. R. 10152; *McClellan* v. *Commissioner* (CCA-2), 117 F. (2d) 988, 26 A. F. T. R. 487; *Thornley* v.

Commissioner (CCA-3), 147 F. (2d) 416, 33 A. F. T. R. 684; *Kessler* v. *United States* (CCA-3), 124 F. (2d) 152, 28 A. F. T. R. 620. In *United States* v. *Landreth*, 164 F. (2d) 340, the Fifth Circuit held that the sale by a taxpayer of his interest in a joint adventure constituted the sale of a capital asset. It was there said:

> "The Court held that these taxpayers did not merely assign future income but parted with title to the corpus of the estate from which income was expected to be produced. We agree that the transaction involved was a joint adventure and that the sale of the taxpayer's rights was the sale of capital assets. * * *"

The gist of the petitioner's argument is that the decisions of the various courts on this question have been wrong since 1935, when The Tax Court decided the *Humphrey* case. The petitioner argues that it was the Congressional intent to tax partners as though they personally owned the assets of the partnership. Yet, the courts have been deciding otherwise since 1935.

It is established that if statutory provisions have a judicially settled meaning it is presumed that Congress legislated in the light of such meaning. *United States* v. *Merriam*, 263 U. S. 179, 187, 4 A. F. T. R. 3673; *The "Abbotsford"*, 98 U. S. 440, 444; *Kepner* v. *United States*, 195 U. S. 100, 124.

It would appear that if the Commissioner is dissatisfied with the decision below that he should ask Congress to remedy the situation rather than ask this Court to engage in judicial legislation. This is particularly true because Congress has repeatedly re-enacted revenue laws in the light of the judicial interpretation followed in the case at bar and which is assailed by the Commissioner.

It should also be remembered that as recently as May 17, 1948 (334 U. S. 819) this Court denied certiorari in *Commissioner of Internal Revenue* v. *Lehman*. The petition in the *Lehman* case stated the first question to be the identical

question here involved. As the petition in the case at bar (p. 17) indicates, the Commissioner is as dissatisfied with the action of this Court in denying certiorari in the *Lehman* case as he is with the established law on the subject. Since this Court's denial of certiorari in the *Lehman* case, there have been no developments which in any way change the situation.

It may also be observed that the rule the taxpayer contends for, and which is as decided below, results in ease of administration. If such sales are treated as sales of capital assets, the computation of the tax will be simple. However, if each asset must be considered and its status determined, a tremendous accounting and administrative problem will result.

Petition is Based on Statements Which Are Contrary to the Actual Facts and Are Not Supported by the Record.

The petition states (p. 7):

> "* * * In the present case, a large portion of the partnership assets consisted of accounts receivable, the income from which, as collected, would have been taxable as ordinary income to the taxpayer and to his partners. Yet the decision below permits the taxpayer, who transferred his interest in these receivables to the members of the new firm, to treat the gain attributable to these receivables as though it were capital gain. * * *"

The foregoing statement is not true and is not supported by the record.

The fact is that the partnership books were kept on the accrual basis. Consequently, the accounts receivable shown as assets of the partnership had been taken into partnership income prior to the sale. Taxpayer's distributable portion of such accounts receivable was income to him prior to the sale. By paying the capital gains tax, the taxpayer in reality has paid tax twice on these accounts re-

ceivable. He is not avoiding tax as the Commissioner implies.

There is nothing in the record to show that the accounts were not kept on an accrual basis. The record does show reserves and accrued items which are customarily used in accrual bookkeeping. (R. 20, 21, 22, 30, 31)

Admittedly, the partnership used an inventory (Pet. 4, 7, R. 20). Treasury regulations have always provided that books must be kept in a manner as to clearly reflect income. Likewise, they have provided that if it is necessary to use an inventory, the accrual method of keeping books must be used. ¶ 6068 P-H Fed. Tax Service. The present regulations provide:

> "* * * in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method."

In view of the regulation just quoted, it is obvious that the Commissioner would not have accepted the partnership returns had they not been based upon accrual accounting.

The Commissioner also argues that depreciable property could not be converted into capital gain by the partnership. Such is not the case. Section 117(j), Internal Revenue Code, specifically includes within the capital gains provisions gains or losses from the sale or exchange of property used in the trade or business which is held for more than six months and which is of a character subject to the allowance for depreciation. This section is set out in full at page 9 hereof as the Commissioner's quotation from Section 117 does not include sub-section (j).

Because of the foregoing, it would appear that much of the Commissioner's argument is based on statements which are not true and which are not supported by the record.

Conclusion.

In this case, the petition should be denied for the following reasons:

(1) The decisions below are based upon firmly established judicial and legislative interpretation.

(2) The petition is based to a large extent upon statements which are not true and which are not supported by the record.

Respectfully submitted,

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July 13, 1949.

APPENDIX.

INTERNAL REVENUE CODE:

"Sec. 117(j). Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.—

"(1) Definition of property used in the trade or business.—For the purposes of this subsection, the term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Such term also includes timber with respect to which subsection (k)(1) or (2) is applicable.

"(2) General rule.—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

"(A) In determining under this paragraph whether gains exceed losses, the gains and losses described

therein shall be included only if and to the extent taken into account in computing net income, except that subsections (b) and (d) shall not apply.

"(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion."